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SUBJECT: DOMINICAN ECONOMY SLOWING DOWN; GODR RUNNING OUT OF MONEY

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¶1. (U) Summary: The recent economic slowdown and global financial crisis are now showing its affects on the economy and finances of the Dominican Republic. There were a large number of layoffs in December in the textile, mining and tourism sectors. Economists predict that the full impact of the U.S. slowdown will hit the country in 2009 through decreases in remittances, tourism and investment. The International Monetary Fund (IMF) forecasts that Dominican GDP will grow 1.8 percent in 2009 compared to an estimated 4.8 percent in 2008. The GODR is facing serious challenges in funding the 2009 budget and is seeking budget support assistance from the Inter-American Development Bank (IDB) and the World Bank (WB). Post does not expect our assistance priorities to change as a result of the crisis; in fact, the programs supporting rural agriculture and sustainable tourism development will be even more important in helping the economy to become more diversified and competitive. End Summary.

Unemployment up, exports down

¶2. (U) December was a rough month for workers in the DR as the largest textile apparel company, the largest nickel mine, and the largest tourism investment project all announced significant layoffs (ref E). According to the Labor Ministry, 120,000 people lost their jobs in the last 24 months in the formal sector. However, the formal sector only represents 44 percent of the total labor force in the country. The Dominican textile industry has been losing competitiveness for some time due to increased competition from China and the high cost of doing business in the DR. The closure of the Falconbridge nickel mine in August 2008 was originally supposed to have been only for four months, but has now been extended indefinitely as a result of decreased world demand for nickel. While overall the tourism sector seems to be holding steady in the current high season (due to advanced bookings), the industry is bracing for a tough year. The largest tourism investment project, Cap Cana, has suspended all operations pending its ability to obtain additional international financing (ref F).

¶3. (U) Exports from the U.S. to the DR increased by about 15 percent in 2008, to over USD 5.6 billion, while DR exports to

the U.S. dropped by about 5 percent. A great deal of attention has been given to the overall decrease in exports, largely due to textiles, however the CAFTA-DR trade agreement has also created new opportunities, with sharp increases in exports to the U.S. of nontraditional agricultural products and other items such as footwear, cosmetics and dairy products. Overall the commercial and economic relationship between the Dominican Republic and the United States was strengthened by CAFTA-DR, but the Dominican consumer has not seen many tangible benefits from the agreement, mostly due to the lack of competition and continued protection of basic food items in the Dominican market. Foreign Direct Investment (FDI) from the U.S. to the DR increased by 16.4 percent in 2008. The U.S. Commercial Service office in Santo Domingo continues to see increased interest from U.S. firms in the Dominican market, with CAFTA-DR being a big factor in generating that interest.

¶4. (U) The Executive Vice President of the Dominican Free Trade Zone Association Jose Torres told Econoff that he expects non-apparel companies in the free trade zones (FTZ) to remain relatively static for 2009. Despite the fact that 90 percent of the FTZ exports go to the U.S., he said he was optimistic that the electronic and medical supply companies, as well as the growing number of call centers, would not be negatively affected. Torres acknowledged that efforts to attract auto-related businesses would likely suffer. He emphasized the need for the GODR to improve the competitiveness of the export sector which faces high costs and, in his view, an overvalued exchange rate. Between March 2007 and March 2008, 104 new permits were granted by the Dominican government to companies to establish businesses in

FTZs, for a projected investment of over USD 5 billion. How much of this investment will be realized in the current economic climate remains to be seen. However, further diversification of FTZ products and export markets would help mitigate the negative effects of reduced U.S. demand for items such as textile products.

GODR slow to respond to economic concerns

¶5. (U) In the face of increasing public concern over the deteriorating economic situation and after months of denying the global crisis would affect the DR, President Fernandez gave a speech to the nation on December 8 where he called for a national summit to address the economic crisis. The summit, which has been scheduled for January 28, will include participants from all of the political parties as well as civil society organizations. The Minister for the Economy, Development and Planning, Temistocles Montas, who is in charge of organizing the event, told the media the objective of the summit is to identify short and long term measures to address the negative impacts of the economic crisis. However, civil society groups are calling for the agenda to include other critical problems facing the country including narco-trafficking, corruption, and increasing crime.

¶6. (U) On January 2, the Central Bank lowered its interest rates, a move that was welcomed by the private sector in the hopes that commercial interest rates would soon follow. Further interest rate reductions by the Central Bank are expected in early 2009. Private consumption has slowed significantly as a result of higher interest rates in 2008 and is expected to continue to decline as a result of lower remittances and increased unemployment. The International Monetary Fund predicts that Dominican GDP will grow 1.8 percent in 2009 compared to an estimated 4.8 percent in 2008. In a letter of intent to the IMF that is part of its post program monitoring process, the GODR emphasized that it would adhere to a realistic fiscal program, including a budget that calls for a 1.7 percent non-financial public sector deficit. However, the government is optimistically predicting 3 percent GDP growth and maintains that there will be no drop in foreign direct investment. Despite the government,s positive outlook, Standard and Poor,s recently downgraded

the Sovereign rating from &B plus8 to &B8 due to &the country,s future economic prospects and the recent fiscal difficulties experienced by the country all within a weak institutional context.8 Standard and Poor,s estimates that the 2008 deficit will reach 4.5 percent of GDP, or approximately USD 1.034 billion. (The original budget projected a primary surplus.)

¶7. (SBU) While the government has attempted to maintain a positive outlook on the country,s ability to weather the global economic crisis, at the end of 2008, the government was forced to revise down its fiscal revenue projections for 2009 due to the prospects of slowing economic growth while expenditures were maintained at levels in the revised 2008 budget. The government,s ability to finance the 2008 and 2009 deficits will be a significant challenge. Locating funding to finance the USD 300 million electric sector deficit that was accrued in 2008 continues to be a challenge for the Office of Public Credit since local capital is expensive (24 percent) and limited, while international markets are for the most part closed to speculative &B8 rated credits. In addition, the international financial institutions are reluctant to provide budget support without a demonstration that the government is making the needed reforms in the electricity sector. The need for an additional USD 300 million exacerbates the challenge of funding the 2009 budget. The prospect of decreasing fiscal revenues places the government in a difficult fiscal situation and puts in question whether the GODR will have the capacity to meet its social and investment requirements. The high cost of financing will further increase the portion of the budget allocated to debt service and result in greater rigidities in terms of expenditure options.

¶8. (SBU) The government is expected to request a USD 300 million emergency fiscal loan from the Inter-American

Development Bank (IDB) for budget support in addition to a USD 500 million loan to the Central Bank for a line of credit to provide export financing to local banks. According to local IDB representative Manuel Labrado, there is no conditionality on the budget support loan which the government originally mentioned could be used to pay the electricity generators, but now is reportedly considering using for other purposes. The government is also seeking additional funding from the World Bank possibly in the form of two USD 150 million development policy loans for budget support. Local WB representative Roby Senderowitsch told Econoff that one loan proposal to provide social protection in the face of the economic crisis and reduce the vulnerability of the country has already been made to the GODR. The WB is waiting for a response from government officials who have internal disagreements over the conditions of the loan. The WB is seeking assurances that social programs will be protected and progress would be made on energy reform. Senderowitsch acknowledged that it would not be possible to bring the loan before the WB Board without some measures on energy reform given that another energy sector loan may be cancelled due to the inability of the GODR to meet the reform requirements. He noted that the second proposed loan is in response to a request from the Ministry of Finance for additional budget support but the WB has not yet identified a topic for the loan.

USG assistance priorities remain the same

¶9. (U) USAID currently has two relevant economic growth programs, one targeted at increasing exports of fruits, vegetables and wood products to global markets and a second designed to increase the number of tourists visiting the tourism cluster areas. Both of these programs are contributing to the diversification of the Dominican economy and improving competitiveness, two important objectives during this difficult economic period. Post does not expect the agriculture program objectives to be significantly affected because the demand for the products being sold to

niche markets (especially fruits and vegetables) will most likely not decrease as much as demand for other consumer products, especially the large consumer items. However, the demand for wood furniture may decrease more than the other products because of its higher income elasticity. On a positive note, the fall in global petroleum prices should result in lower prices for gasoline and fertilizers. In regard to the sustainable tourism program, while the number of tourists coming to the DR this year is expected to fall, especially on the high end, there are some opportunities for the DR to attract tourists that might otherwise have traveled to Europe or Asia. The long-term goal of diversifying the tourism sector and improving environmental protection should help the DR become more competitive relative to other neighboring countries and contribute significantly to the sector being able to weather effectively this current, and future, economic crises.

¶10. (U) Beyond the issues outlined above in para 9, Post does not expect ongoing assistance activities or priorities to be adversely effected by the crisis. USAID activities in health, education, and democracy should continue as planned. Under the USAID-GODR development assistance agreement, the GODR has committed to contributing resources to joint assistance programs. The contribution is primarily in-kind and so should not be at serious risk of being reduced. Given the current economic climate, USAID is monitoring GODR compliance with a first step in this regard being a meeting scheduled in the coming weeks to further define the government,s contribution. Post will also monitor GODR investments in education and health to anticipate any further backsliding on the MCC criteria. Any potential issues with regard to host government contributions to the assistance program, the MCC criteria, or USG assistance in general, will be reported.
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